Part One

What Happened and Why, Where Are We Now, and What Does the Future Hold?

Chapter 1

What Happened during the Housing Bubble?

Talk to your parents or grandparents about buying their first home and they'll tell you it was the fulfillment of the American dream, a long process that involved years of saving and sacrificing to gather enough cash for the 20 percent down payment. They'll tell you that the day they bought their first home was one of the greatest days of their lives, that it represented more than just a place to live. In fact, that home was the single biggest purchase most would ever make, and it represented stability, safety, and security for themselves and their families.

In those days a mortgage was regarded as a sacred obligation, to be paid off steadily over time. And when it was paid off, there was often a mortgage-burning party to celebrate owning the house free and clear.

Home Prices over Time

Historically, there was good reason to believe that homes represented stability, safety, and security. For more than half a century, home prices had marched steadily upward at a rate exceeding inflation by about one-half of 1 percent annually, with very little volatility, as shown in Figure 1.1.

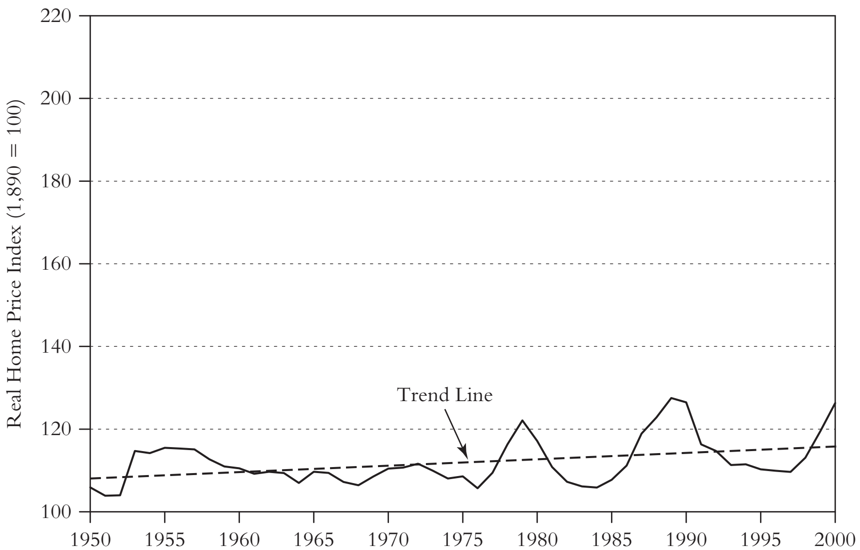

Figure 1.1 Real Home Price Index, 1950–2000
SOURCE: Robert J. Shiller, Professor of Economics, Yale University, *Irrational Exuberance: Second Edition,* Princeton University Press, 2005.

Beginning around 2000, however, home prices started to rise at a rapid rate and became completely disconnected from their historical trend line (shown in Figure 1.2).

There were many reasons for the upward movement, as we'll explain in detail in Chapter 2, but the biggest driver of the housing bubble was the simple fact that the amount an average homeowner was able to borrow to buy a house tripled in a relatively short period of time, as shown in Figure 1.3.

Prior to 2000, the typical borrower could borrow roughly three times his income to buy a house. Figure 1.3 shows that in January 2000, a person with pretax income of nearly $34,000 (the national average) could take out a mortgage of 3.3 times this amount, or $110,000. Of course, the borrower had to have a 20 percent down payment and a decent credit history, and banks were rigorous about evaluating the ability to repay. But all this began to unravel as the years passed.

By January 2004, average pretax income had risen 9 percent to $37,000, but the amount that could be borrowed rose 60 percent

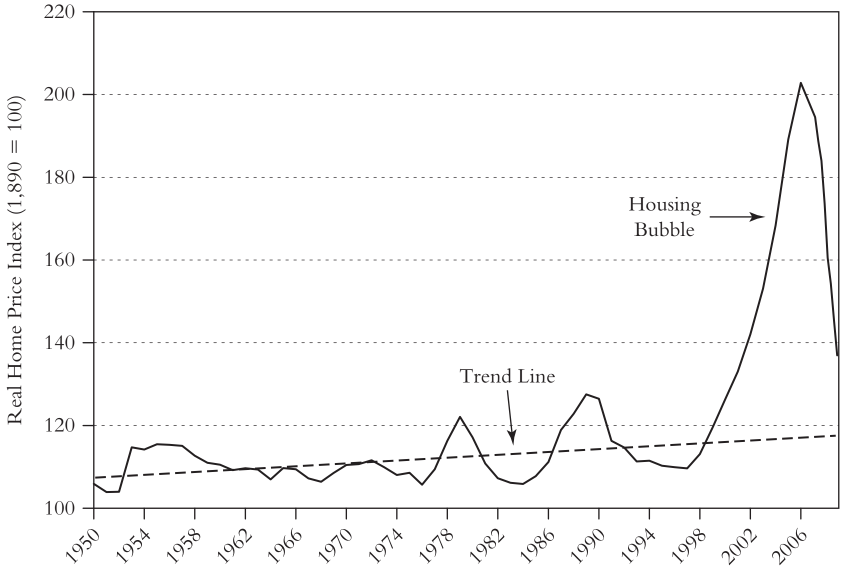

Figure 1.2 Real Home Price Index, 1950–2008
Source: Robert J. Shiller, Professor of Economics, Yale University, *Irrational Exuberance: Second Edition*, Princeton University Press, 2005, as updated by the author.

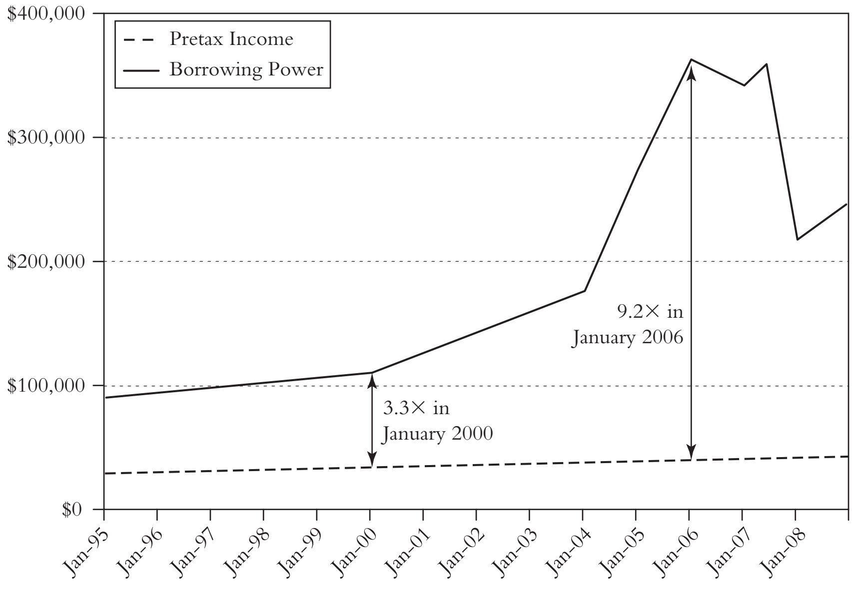

Figure 1.3 Average Income and Borrowing Power
Source: Amherst Securities.

to \$176,000, a 4.8× ratio. A year later, the figures were \$38,000, \$274,000, and 7.2×, and by January 2006, with income of only \$39,600, the amount that could be borrowed to buy a house was an astonishing \$363,000, a 9.2× ratio. This enormous borrowing power persisted for another year-and-a-half until the housing bubble began to burst in mid-2007.

There were a number of factors, including falling interest rates, driving this threefold increase in borrowing power in only six years, but by far the biggest was that lenders grew willing to lend up to the point that debt payments consumed 60 percent of a borrower's pretax income, whereas historically the permitted ratio didn't exceed 33 percent. Worse, little or no down payment or documentation was necessary, and interest-only loans proliferated.

Suddenly throwing such a massive amount of capital at a relatively stable asset base caused prices to skyrocket, which led to a self-reinforcing cycle: In order to afford a home, prospective homeowners had to borrow more and take on risky, exotic mortgages instead of conservative 30-year, fixed-rate, fully amortizing mortgages. In turn, exotic mortgages and loose lending terms allowed homeowners to borrow much more money, thereby driving prices ever higher.

The bubble manifested itself in different ways in different parts of the country. As discussed later, in inner cities like Detroit, equity-stripping schemes were common; in Florida, Arizona, and Nevada, there was widespread speculation and overbuilding; and in California, which has 10 percent of the nation's homes but is where 34 percent of the foreclosures are happening (44 percent by dollar value), the bubble was primarily an affordability problem. That's not to say there wasn't equity stripping in California's inner cities nor an affordability problem in Florida, but these are the general characterizations.

Figure 1.4 shows what happened to housing affordability in three cities in southern California: Los Angeles, Riverside, and San Diego. One can see that the percentage of households that could afford the average home in these three cities, as measured by the National Association of Home Builders (NAHB)/Wells Fargo Housing Opportunity Index, plunged as this decade progressed, to the point that fewer than 10 percent of households could afford the average home using a standard mortgage.

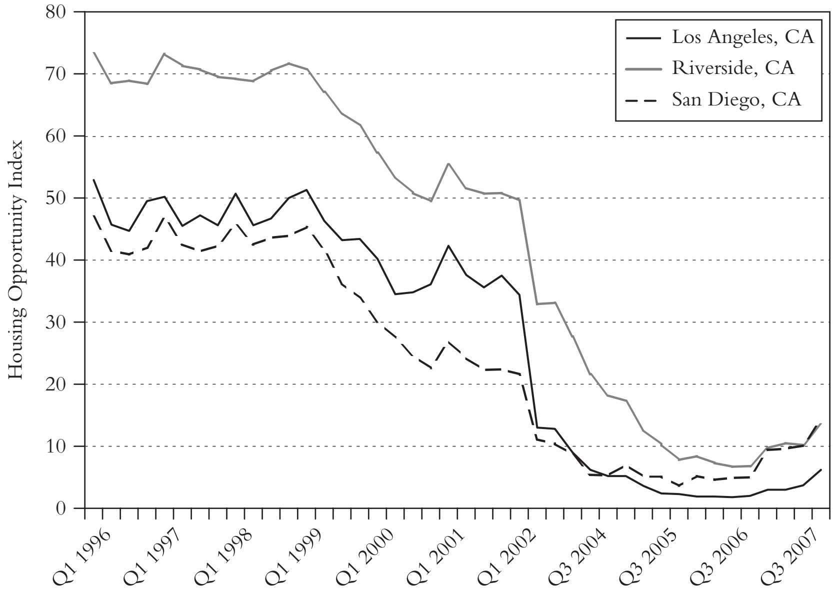

Figure 1.4 Home Affordability in Three Cities
SOURCE: Copyright © National Association of Home Builders 2009. All Rights Reserved. Used by permission. "NAHB" is a registered trademark of National Association of Home Builders. "Wells Fargo" is a registered trademark of Wells Fargo & Company.

Homes as ATMs

Another factor was at work as well: As home prices rose and interest rates dropped, millions of Americans were able to refinance their mortgages at lower rates but also—this is critical—take out *bigger mortgages*, thereby converting the rising value of their homes into cash. Called a cash-out refinancing or refi, this practice soared during the bubble. In total, as shown in Figure 1.5, Americans pulled more than $2.5 trillion out of their homes from 2004 to 2007, fueling consumer spending and accounting for approximately 8 percent of total disposable income during that period.

The combination of these factors meant that Americans were taking on more and more mortgage debt and had less and less equity in their homes, as shown in Figure 1.6. In fact, in 2007, for the first time ever, American homeowners had more debt than equity in their homes.

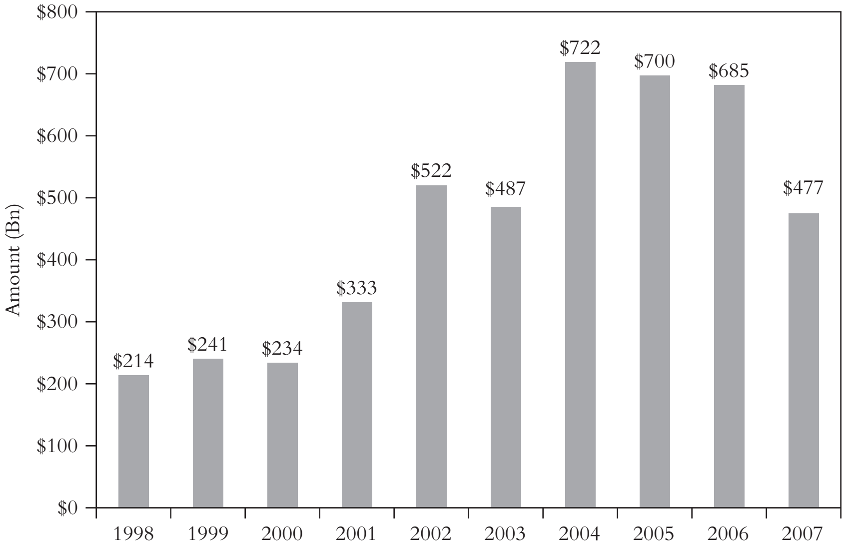

Figure 1.5 Net Home Equity Extraction

SOURCE: Updated estimates provided by James Kennedy in "Estimates of Home Mortgage Originations, Repayments, and Debt on One-to-Four-Family Residences," by Alan Greenspan and James Kennedy, Federal Reserve Board Finance & Economics Discussion Series (FEDS) working paper no. 2005-41. Home equity extraction is defined in the paper as the discretionary initiatives of homeowners to convert equity in their homes into cash by borrowing in the home mortgage market. Components of home equity extraction include cash-out refinancings, home equity borrowings, and "home turnover extraction" (originations to finance purchases of existing homes minus sellers' debt cancellation).

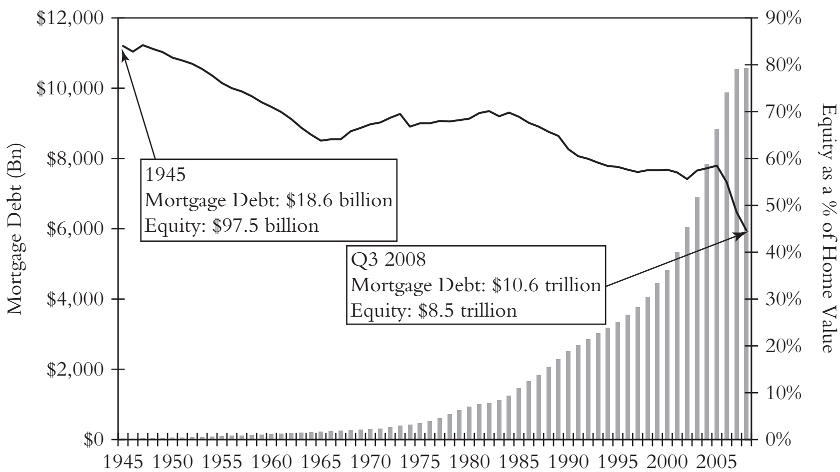

Figure 1.6 Mortgage Debt and Home Equity

SOURCE: Federal Reserve Flow of Fund Accounts of the United States.

The Collapse of Lending Standards

Lending standards collapsed to an almost unimaginable degree during the great bubble, to the point that in some areas if you had a pulse, you could get a mortgage. The collapse manifested itself in many ways.

In 2001, the combined loan-to-value ratio for the average mortgage was 74 percent, meaning the buyer had put down 26 percent of the cost of the home (see Figure 1.7). When doing any kind of lending, it's critical that the borrower has meaningful skin in the game, so there is a strong incentive to repay the loan, even if the value of the asset falls.

Over the next five years, the average loan-to-value ratio rose to 84 percent, meaning that the average borrower was putting down only 16 percent, affording lenders much less protection in the event home prices tumbled. The situation was even more extreme for first-time home buyers, who were putting down only 2 percent on average by early 2007.

Not surprisingly, the percentage of mortgages for which the borrower put no money down—and was effectively getting a free call

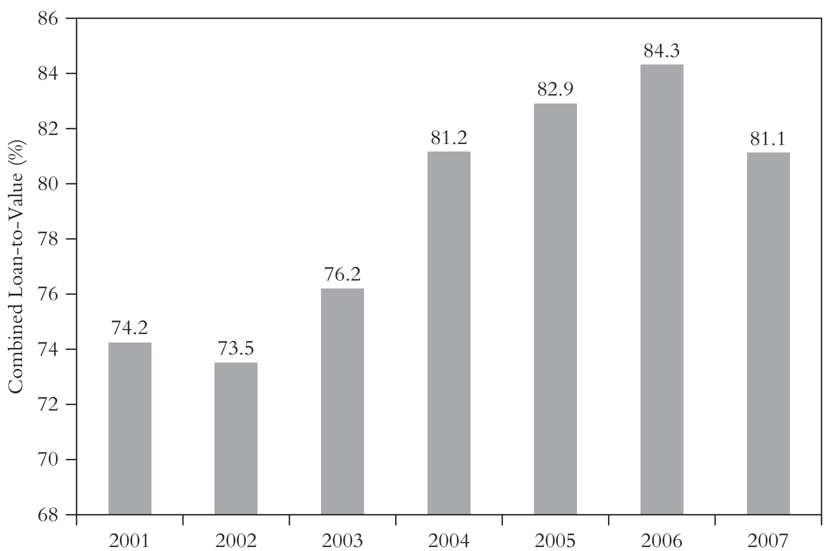

Figure 1.7 Combined Loan-to-Value Ratio
SOURCE: Amherst Securities, LoanPerformance.

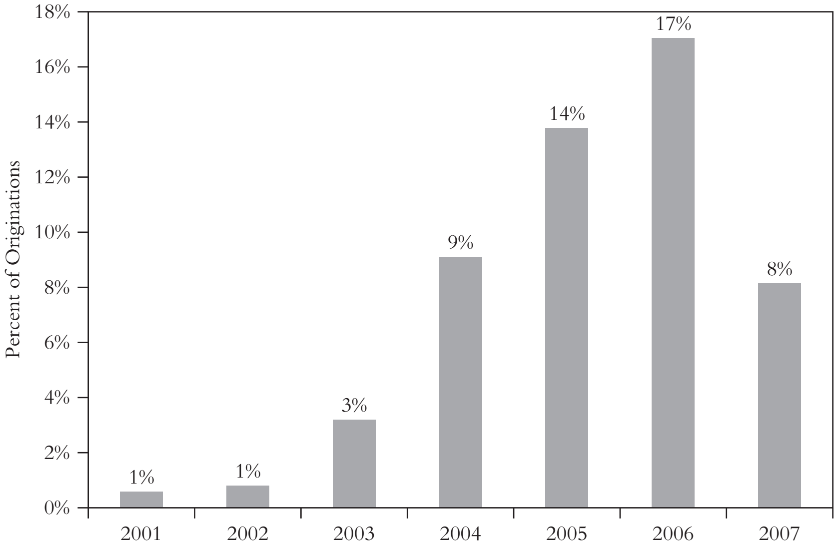

Figure 1.8 Mortgage Loans with 100 Percent Financing
SOURCE: Amherst Securities, LoanPerformance.

option on home price appreciation—soared from virtually nil to one-sixth of all mortgages in 2006, as shown in Figure 1.8.

Another change in lending practices compounded the problem. Historically, a lender was careful to verify a borrower's income and assets by asking to see pay stubs and tax returns—an obvious precaution to ensure that the borrower could afford the payments on the mortgage. There were exceptions made for certain self-employed borrowers like doctors, but this was not common. During the bubble, however, such requirements went out the window as low- and no-documentation mortgages rose to account for nearly two-thirds of all mortgages at the peak, as shown in Figure 1.9. More and more often, a lender simply looked at a borrower's credit score and the appraisal on the house and made the loan based on whatever the borrower stated as income.

Limited-documentation loans were an invitation for fraud, either by the borrower or by the mortgage broker (often both), and fraud is indeed what happened: One study shows that 90 percent of stated-income borrowers overstated their incomes, half of them by more than 50 percent. Another study found that "the average income for stated-income applicants

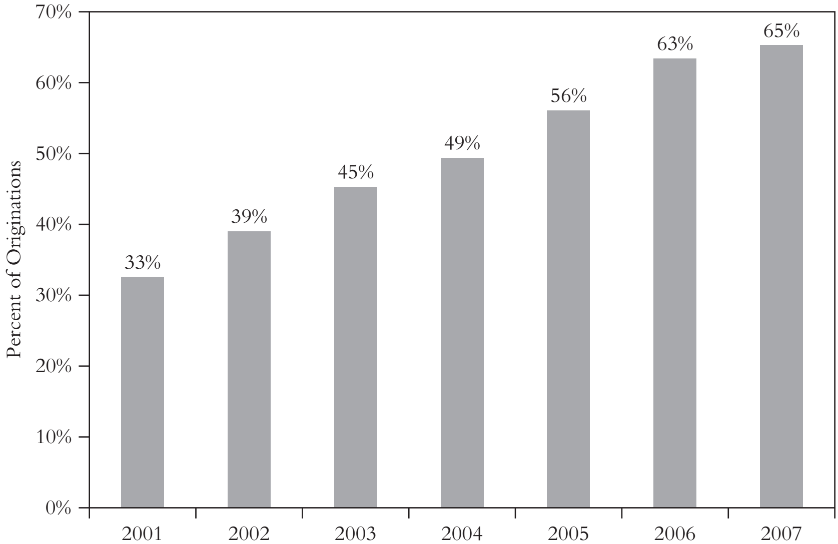

Figure 1.9 Mortgage Loans with Low and No Documentation (aka "Liar's Loans")
SOURCE: Amherst Securities, LoanPerformance.

was 49% higher than the average for fully documented loans and the average income on loans with limited documentation was 92% higher."[1] It's little wonder that these loans are now known as liar's loans.

The most dangerous loans of all are those for which the borrower puts no money down and the lender doesn't bother to check income or assets. Such loans were unheard-of prior to the bubble, but they accounted for 11 percent of all mortgages in 2006, as shown in Figure 1.10.

Historically, one of the most important factors to consider when making a loan was the credit history of the borrower. People who had previously defaulted on many of their loans or bills were rightly considered poor risks and were charged high rates for a mortgage—or, more likely, couldn't get one at any rate.

The most common measurement of a person's credit history is called a FICO score, which ranges from 350 to 850. The median score is 723, and 45 percent of people fall between 700 and 799.[2] Roughly speaking (lenders and analysts use different cutoffs), a score under somewhere between 620 and 660 is called subprime, above 720 is

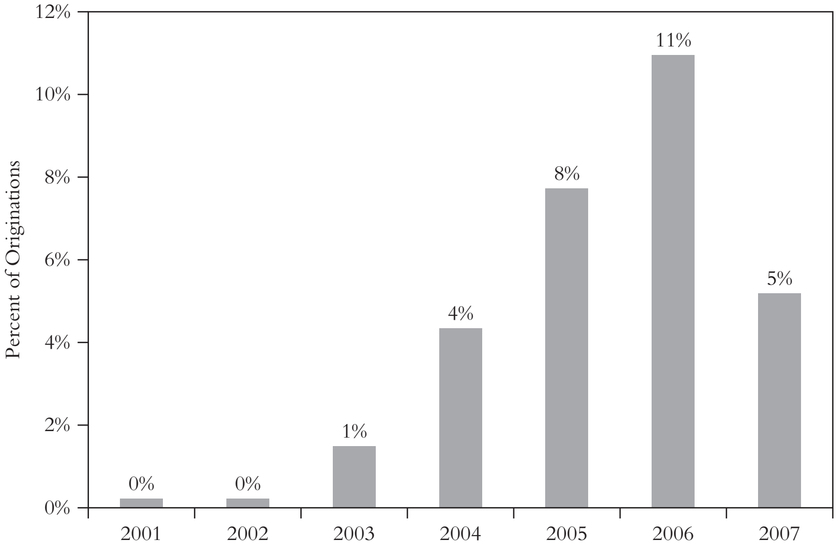

Figure 1.10 Mortgage Loans with 100 Percent Financing and Low/No Documentation
SOURCE: Amherst Securities, LoanPerformance.

considered prime, and in between is called Alt-A, though this category is also defined by limited-documentation loans.[3]

As shown in Figure 1.11, prior to 2002 subprime mortgages were rare, never far exceeding $100 billion worth per year, but then the volume rose rapidly, peaking at roughly $600 billion per year in 2005 and 2006. Subprime had been a small industry generally characterized by reasonable lending standards, but it ballooned to the point that nearly anyone, no matter how poor or uncreditworthy, could get a mortgage, often with no money down and no requirement to document income or assets. Such mortgages were called NINJA loans: no income, no job or assets. True madness.

As much attention as subprime mortgages have garnered in the media lately, it is important to understand that they were just a small part of the marketplace—only 20 percent of the market at the peak of the bubble. Unfortunately, the bubble extended far beyond the subprime arena and, as we discuss later, losses among the other 80 percent of loans that were written during the peak years of the bubble will cause many problems going forward.

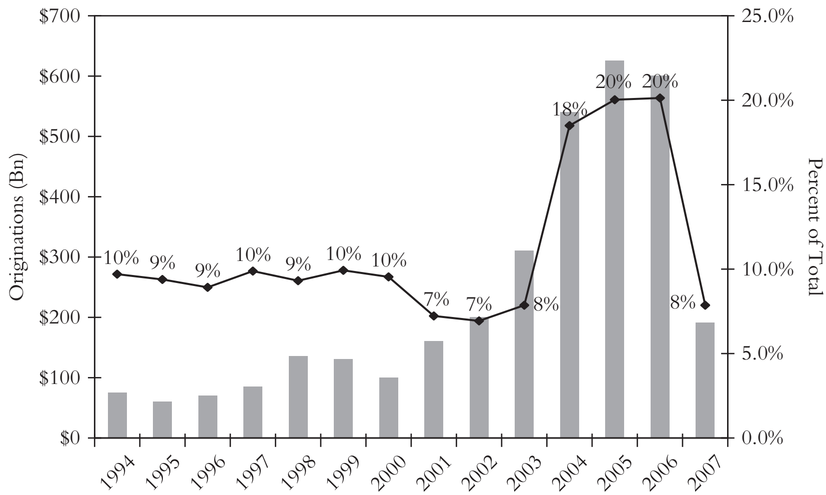

Figure 1.11 Subprime Mortgage Volume and Percentage of Total Originations, 1994–2007

SOURCE: *Inside Mortgage Finance*, Inside Mortgage Finance Publications, Inc. Copyright 2009. Reprinted with permission.

To understand how far lending standards had fallen by the peak of the bubble, let's hear from Mike Garner, who worked at the largest private mortgage bank in Nevada, Silver State Mortgage, who was interviewed by *This American Life* in early 2008:[4]

Alex Blumberg, *This American Life*: Mike noticed that every month, the guidelines were getting a little looser. Something called a stated income, verified asset loan came out, which meant you didn't have to provide paycheck stubs and W-2 forms, as they had [required] in the past. You could simply state your income, as long as you showed that you had money in the bank.

Mike Garner: The next guideline lower is just stated income, stated assets. Then you state what you make and state what's in your bank account. They call and make sure you work where you say you work. Then an accountant has to say for your field it is possible to make what you said you make. But they don't say what you make, just say it's possible that they could make that.

Alex Blumberg: It's just so funny that instead of just asking people to prove what they make there's this theater in place of you having to find an accountant sitting right in front of me who could very easily provide a W-2, but we're not asking for a W-2 form, but we do want this accountant to say, "Yeah, what they're saying is plausible in some universe."

Mike Garner: Yeah, and loan officers would have an accountant they could call up and say, "Can you write a statement saying a truck driver can make this much money?" Then the next one came along and it was no income, verified assets. So you don't have to tell the people what you do for a living. You don't have to tell the people what you do for work. All you have to do is state you have a certain amount of money in your bank account. And then the next one is just no income, no assets. You don't have to state anything. Just have to have a credit score and a pulse.

Rising Home Ownership

One apparent benefit of what was going on was that home ownership rates were going up substantially, as shown in Figure 1.12. Initially, this

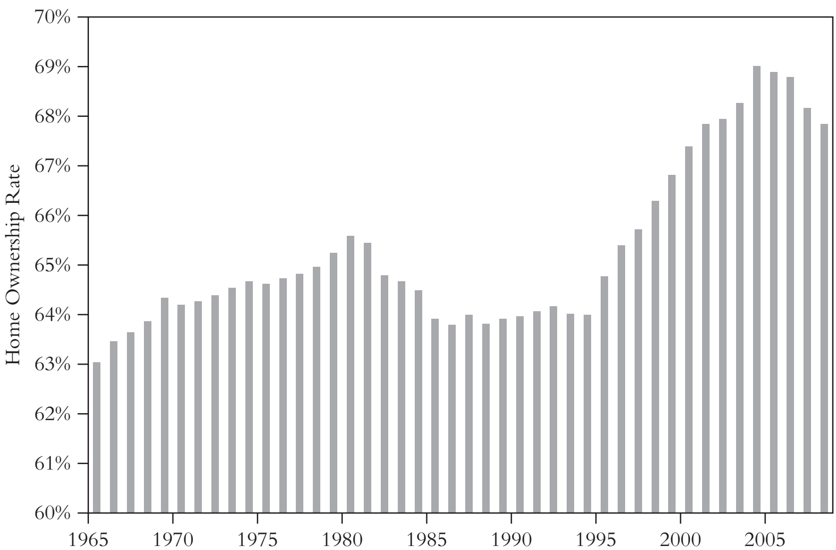

Figure 1.12 Percentage of Households Owning Homes
SOURCE: U.S. Census Bureau.

was a good thing, as lenders stopped red-lining low-income, typically minority areas, which helped many people achieve the American dream of home ownership.

But this dream turned into a nightmare during the bubble, as people were given mortgages they couldn't afford, which has already led to over a million subprime borrowers suffering the financial and emotional trauma of losing their homes. The reality is that only a small fraction of people with poor credit histories are ready to become homeowners; the remainder of people with low incomes, uneven employment histories, and/or an inability to control their spending should simply continue renting until their financial situation is stable enough to support a mortgage. As Warren Buffett noted in his 2008 annual letter to Berkshire Hathaway shareholders, "Putting people into homes, though a desirable goal, shouldn't be our country's primary objective. Keeping them in their homes should be the ambition."

The Human Face of the Housing Bubble

So far, we've told the story of the mortgage meltdown with statistics, charts, and graphs, which makes it easy to forget that nearly every mortgage involves real people and families and their homes. Millions of Americans are struggling to pay their mortgages, and a meaningful percentage will lose their homes, which is often an economic and emotional catastrophe.

Yes, some people were greedy and reckless or engaged in outright fraud and should lose their houses, but many others are vulnerable people who were exploited in equity-stripping schemes, and many more were misled by the housing and mortgage industry, which aggressively marketed the message that housing was a totally safe investment because home prices never go down and one can always refinance. And for decades this had proved to be true, so it's little wonder that a lot of people got caught up in the bubble and took on mortgages they couldn't afford.

To put a human face on this bubble, we'd like to share some stories we've come across that capture a wide range of the people who got caught up in the frenzy.

Florida's Speculative Frenzy

A truth of markets, whether they be stocks or tulip bulbs, is that rising prices attract speculation. Real estate is no different. Beginning in the late 1990s, housing prices started rising at phenomenal rates. With people able to buy houses with little or no money out of pocket, the returns were staggering and speculators moved in with a vengeance. Property flipping became common, especially in new developments and among condominiums, whereby homes were purchased at preconstruction prices and then resold at higher prices a short time later. It is estimated that at the height of the bubble 85 percent of the condos in the overheated Miami market were bought by investors who had no intention of living in the properties. The speculation served to create false demand and push prices even higher.

As the mortgage market changed, so did the way home ownership was viewed, which had a striking impact on the structure of the mortgage and housing markets. Many homeowners no longer sought to pay down their mortgages but instead saw their homes as investments and sources of cash. They became accustomed to refinancing on a regular basis, effectively using their homes as ATMs to fuel consumer purchases or, in some cases, to buy additional property to speculate on the fast-rising real estate markets.

The *New Yorker* published a lengthy report, "The Ponzi State," that captures the speculative frenzy that took place in Florida.

> By 2005, the housing market in Florida was hotter than it had ever been, and the frenzy spread across all levels of society. Migrant farmworkers took jobs as roofers and drywall hangers in the construction industry. Nearly everyone you met around Tampa had a Realtor's license or a broker's license or was a title agent. Alex Sink, the state's chief financial officer and a Democrat, said, "When the yardman comes and says he's not going to mow your yard anymore because he's going to become a mortgage broker, that is a sure sign that something is wrong." Flipping houses and condominiums turned into an amateur middle-class pursuit. People who drew modest salaries at their jobs not only owned a house but bought other houses as speculators, the way average Americans

elsewhere dabble in day trading. Ross Bauer, a manager at a Toyota dealership in Tampa, told me that between 2000 and 2007 he bought and sold half a dozen properties, in a couple of instances doubling his money within two years. "Looking back, it was right in our face," he said. "That's a heart attack. It's not normal."

Jim Thorner, a real-estate reporter in the Tampa office of the St. Petersburg *Times*, said, "There were secretaries with five to ten investment homes—a thirty-five-thousand-dollar salary and a million dollars in investments. There's no industry here, only houses." When Thorner went to buy a new house, in 2005, the customer ahead of him in line at the sales center said that he intended to turn his property around in six months and make fifty thousand dollars. It was not an outlandish plan. Home values around Tampa rose twenty-eight per cent that year. "I'm telling you, it was the Wild West," Alex Sink said. "And Florida has always been susceptible to the Wild West mentality. If it's too good to be true, we're going to be involved in it."

In Fort Myers and the neighboring city of Cape Coral, two hours south of Tampa, things got wilder than anywhere else. A Fort Myers real-estate agent named Marc Joseph, who entered the business right out of college, in 1990, and had the jaundiced eye of a veteran, told me, "Money was flowing, easy money. Anybody could qualify—I mean anybody." He knew a bank teller with an annual salary of twenty-three thousand dollars who had received a two-hundred-and-sixteen-thousand-dollar mortgage, with no money down and no income verification—not even a phone call from the lender. "I wish I could say the market here was driven by end users and retirees, but it wasn't. Two-thirds were speculators. You could flip 'em before you had to close on 'em." Karen Johnson-Crowther, another real-estate agent in Fort Myers, showed me the sales history of a property in an upscale gated community which she had recently bought at a foreclosure auction. Building had begun in 2005. On December 29, 2005, the house sold for $399,600. On December 30, 2005, it sold for $589,900. On June 25, 2008, it was foreclosed on. Johnson-Crowther bought it in December for $325,000. I said that the one-day increase in value must have been some kind of record, and she looked at me pityingly: "No."

When I told Alex Sink about the house that had appreciated by almost 50 percent overnight, she said, "That's a fraudulent transaction." According to an investigative series in the Miami *Herald*, oversight by the state's Office of Financial Regulation and its commissioner, Don Saxon, was so negligent that more than ten thousand convicted criminals got jobs in the mortgage business, including four thousand as licensed brokers, some of whom engaged in fraudulent deals. Until the rules were recently changed, felons in Florida lost the right to vote but could still sell mortgages.[5]

Subprime Borrowers Fleeing Bad Neighborhoods

Most reports about the mortgage bubble, like the previous one, focus on people speculating or buying more house than they could afford, typically using exotic mortgages. But less often told are the stories in which mortgage companies exploited low-income, poorly educated, disproportionately minority borrowers. These schemes typically included many (if not all) of the following techniques:

- Paying higher fees or rebates to mortgage brokers for inflating interest rates or using exotic mortgages.
- Charging above-market interest rates, excessive points, and exorbitant fees.
- Putting people into adjustable-rate mortgages (ARMs) without regard for whether they could make the monthly payments after the teaser rate expired.
- Establishing prepayment penalties that prevented borrowers from refinancing.
- Promising one thing verbally, but having the documents say something else.
- Generating fees and stripping borrowers' equity through unnecessary refinancings.

60 Minutes has done a number of excellent reports on the mortgage crisis. In one that aired in January 2008,[6] Steve Kroft interviewed an African-American couple who purchased a house for $436,000 in Stockton, California, from which they ran a small day care center. Kroft gave the background:

> They say they wanted to move to a better neighborhood. A mortgage broker approached the Fontenots and offered to get them a loan. They told her the most they could afford . . . was $2,500 a month. But the monthly payment on the adjustable rate mortgage she gave them quickly jumped to $4,200.

Here's the conversation:

> "Did you understand any of this?" Kroft asks.
>
> "No, not really. Not much of it," says Phil Fontenot, who also says he didn't have a lawyer look over the paperwork.
>
> "But you knew this was a big decision, right? You were borrowing hundreds of thousands of dollars," Kroft remarks.
>
> "I didn't really look at it like that," Fontenot says.
>
> "How did you look at it?" Kroft asks.
>
> "I looked at it as far as my family. I can get my family off of this block," he replies.
>
> "And that we could pay the payments that she said that we could pay," Fontenot's wife Kim adds. "But after it was all said and done, and the paperwork was drawn up, it was something different."

Here's a similar example from a CNBC report:[7]

> Cynthia Simons craved a better life for her family and wanted to leave the crime-ridden area of Compton, California. She thought her prayers were answered by a mortgage broker from her church who found the family a house in a safe neighborhood. Was Simons' dream house too good to be true?
>
> Simons says her broker grossly exaggerated her income and without her knowledge arranged TWO mortgages . . . one a

> loan for her down payment, the other an adjustable rate mortgage on the home.
>
> Now Simons still has the house but can no longer keep up with her mortgage payments.

These are your typical peak-of-the-bubble subprime loans, so it's easy to understand why these loans have been defaulting at catastrophic rates.

Equity Stripping in Inner Cities

You might think the previous stories represent the worst of what mortgage companies did in inner cities, but equity strippings were even worse. In these cases, lenders trolled inner-city areas of Detroit, Cleveland, Newark, Akron, and the outer boroughs of New York, looking for homeowners who had built up equity in their homes so as to convince them to borrow against it. These loans generally had high interest rates and the payments weren't affordable for many of the homeowners, often elderly, on fixed incomes and financially unsophisticated.

Niall Ferguson, in his excellent book, *The Ascent of Money*, describes what happened in one city:

> In the space of ten years, house prices in Detroit—which probably possesses the worst housing stock of any American city other than New Orleans—had risen by nearly 50 per cent; not much compared with the nationwide bubble (which saw average house prices rise 180 percent), but still hard to explain given the city's chronically depressed economic state. As I discovered, the explanation lay in fundamental changes in the rules of the housing game, changes exemplified by the experience of Detroit's West Outer Drive, a busy but respectable middle-class thoroughfare of substantial detached houses with large lawns and garages. . . .
>
> . . . Subprime lending hit Detroit like an avalanche of Monopoly money. The city was bombarded with radio, television, direct-mail advertisements and armies of agents and brokers, all offering what sounded like attractive deals. In 2006 alone, subprime lending injected more than a billion dollars into twenty-two

> Detroit ZIP codes. In the 48235 ZIP code, which includes the 5100 block of West Outer Drive, subprime mortgages accounted for more than half of all loans made between 2002 and 2006. Note that only a minority of these loans were going to first-time buyers. They were nearly all refinancing deals, which allowed borrowers to treat their homes as cash machines, converting their existing equity into cash. Most used the proceeds to pay off credit card debts, carry out renovations or buy new consumer durables.[8]

Addie Polk of Akron, Ohio, is a typical victim of this type of predatory lending. She and her husband moved into a working-class neighborhood in Akron in 1970 and purchased a home for $10,000. Her husband worked at the nearby Goodrich plant and eventually retired from there in 1995, when they finished paying off the mortgage.

After her husband died, Mrs. Polk's only income was Social Security and her husband's small pension, so she began to borrow against the house to pay day-to-day expenses. She refinanced the home four times over the next decade, the last time at the age of 86 in 2005 when Countrywide gave her a 30-year fixed-rate mortgage of $45,620 at 6.375 percent, plus a credit line of $11,380.

This loan should never have been made, as there was no way the elderly widow could afford the monthly payments. Sure enough, she began to miss payments and eventually Fannie Mae, which by then owned the loan, foreclosed on the home. After leaving 30 eviction notices on her door, the sheriff came to evict Mrs. Polk in September 2008. When he knocked on the door, he heard a loud noise. A neighbor crawled through a second-story window and found her lying in bed, a gun beside her. She had shot herself twice.

Fortunately, Mrs. Polk survived and, thanks to the publicity surrounding her case, Fannie Mae quickly forgave her loan. But there are hundreds of thousands of Addie Polks out there in working-class and poor neighborhoods whose loans will not be forgiven and who will lose their homes. They were sold on the idea of using their homes as ATMs and in most cases didn't realize the likely consequence of their actions: the dreaded sheriff's knock on the door and eviction from their homes.

Betty Townes is another elderly African-American widow who is about to lose her home thanks to being sold a series of option ARM mortgages she can't afford. World Savings, now part of Wells Fargo, refinanced her home four times in four years. When Scott Pelley of *60 Minutes* asked her what she was thinking, she replied, "All I know is that they told me this loan was best for me." It turns out that a staff person at World Savings, without her knowledge, declared on the loan application that her income was more than $4,000 per month, based on her husband's income. The only problem? Her husband had passed away! Her true monthly income was only about $1,875.

A final story of equity stripping is that of Clarence Nathan. He worked three part-time jobs and earned about $45,000 annually. He got himself into financial trouble and was able to borrow $540,000 against his house without any income verification. He later learned (after he'd defaulted on the loan) that the broker, who earned a commission of $18,500, had declared his income at $195,000 per year. He commented:

> It's almost like you pass a guy in the street and say, "Lend me $540,000." He says, "What do you do." "Hey, I got a job." "OK."
>
> I wouldn't have loaned me the money. And nobody that I know would have loaned me the money. I know guys who are criminals who wouldn't loan me that, and they break your knee-caps. I don't know why the bank did it . . . $540,000 to a person with bad credit.[9]

One could argue that the Fontenots, Mrs. Polk, Mrs. Townes, and Mr. Nathan should have known better—but who really should have known better: these financially illiterate borrowers or the large, sophisticated mortgage lenders who preyed on them.

WaMu's Depravity

The class action lawsuit against Washington Mutual (WaMu), which can easily be found on the Internet, provides rich fodder for how one of the biggest mortgage lenders in the country went completely off the rails and sank to extreme levels of depravity. JPMorgan Chase is going to have its hands full trying to clean up this mess.

The 470-page complaint is filled with examples from dozens of former employees about how the bank threw its loan standards out the window to underwrite as many mortgages as possible. Obviously fraudulent loans were jammed through. Appraisers were pressured to inflate prices to make loans work. Loans were not properly documented. Loan terms, especially for option ARMs, were not fully explained to buyers. Marketing materials emphasized low initial teaser rates and did not fully explain the loan reset features. Borrowers were encouraged to take fast-track or no-documentation loans, even when a lower interest rate and a more favorable loan structure were available with a fully documented loan. In short, if you had a pulse, you could get a loan from WaMu—after all, with Wall Street willing to buy virtually any loan, what did WaMu care?

Soledad Aviles is one of many examples from the lawsuit. He is an immigrant from Mexico who cannot speak or read English. He was working as a glass cutter and earning a whopping $9 an hour. The combined family pretax income was about $5,000 per month. Despite this, WaMu gave him a home loan of $615,000 and told him payments would be slightly more than $3,600 a month. All of the loan documents were in English and, excited about owning a home, Mr. Aviles signed them.

At 72 percent of the family's income, even $3,600 per month would have been unaffordable, but it turns out that monthly payments were actually $4,800—96 percent of income! So how did WaMu justify this loan? The loan documents showed his income was $13,000 per month. Someone falsified his income, which was what usually happened when a lender was foolish enough to do a low- or no-doc loan.

In situations like this, the borrower quickly defaults and loses the home—but by then WaMu had probably already sold the loan. Unfortunately for WaMu and its equity and debt holders, though, it wasn't able to sell enough of its loans, and the losses on the loans it held caused it to file for bankruptcy in September 2008. But the losses haven't disappeared—they will be borne by JPMorgan Chase and taxpayers for years to come.

Job Loss and Health Emergency Lead to Foreclosure

Job losses now spiraling upward to the highest levels in at least 16 years will surely exacerbate the collapse of the mortgage bubble. In addition, medical bills are contributing to many household financial crises, hardly surprising given that 46 million Americans don't have health insurance.

The *St. Louis (MO) Beacon* told the story of Stacy Haynes,[10] who fell victim to both and lost her home, which she'd purchased in 1999 with a conventional mortgage and a $20,000 down payment. She refinanced it with a GMAC mortgage of $216,000 in the form of an interest-only ARM with an initial interest rate above 8 percent. She was paying over $18,000 a year in interest without a penny of principal being repaid.

Then, in early 2008, disaster struck. Haynes was hospitalized with a critical case of pancreatitis and because she was employed as an independent consultant, she had no health insurance. Then, a few weeks later, she was laid off due to the economic downturn. Unemployed and deeply in debt, she struggled to keep her home, going so far as to sell possessions on eBay and Craigslist to make a few payments.

Haynes also tried to sell the home, but got no offers above the amount of the mortgage (it ended up being sold at foreclosure for $153,000, and the new owner later offered it for $129,900). Haynes had to move in with her daughter and file for bankruptcy.

This isn't a case of greed or exploitation on anyone's part—just another sad story of a life gone awry due to a bad economy and bad luck. Incidentally, contrary to popular perceptions that distressed homeowners behave like speculators and mail in their keys once they're underwater (or upside-down) on their mortgage, note how hard Haynes tried to keep her home, making a few last payments even when it was clear she was going to lose it.

Zombie Homeowers

The media have coined the term *zombie banks* to refer to banks that are crippled by severe losses—but not so severe that they actually go under, so instead they limp along, unable to lend and function properly. Less well understood are the millions of zombie homeowners who are trapped in homes in which they are underwater on their mortgages, unable to sell, move, or save.

Zachary and Tracy Campbell are good examples of zombie homeowners. In 2005 they moved from San Diego to Phoenix and bought a home in Maricopa, a suburb of Phoenix. They scraped together

$50,000 for a down payment on a new four-bedroom home that cost $250,000. The *Wall Street Journal* captures their dilemma:

> Today, Ms. Campbell figures, the home is worth perhaps half what they paid in 2005.
>
> Even that might be optimistic. Along a nearby highway, young men hired by a local real estate brokerage wave red signs touting "Homes From $69.9 K."
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> The Campbells planned to sell their house for a profit after a few years and move back to San Diego before their daughter starts kindergarten. Today, they couldn't hope to sell the house for enough to pay off the mortgage. They fear the down payment they made on the house is money they won't see again. . . .
>
> "We're trapped," says Tracy Campbell, as she watches her 2-year-old daughter romp on a playground. . . .
>
> Some people in the neighborhood are simply walking away from their houses, leaving them for the lenders to foreclose. "We're surrounded by empty houses on three sides," Ms. Campbell says. But she and her husband have kept up on their payments, and want to keep their credit record clean.[11]

The Campbells' situation is perhaps the most common type of problem today, with an estimated 20 percent of all mortgage holders in the United States now underwater. They didn't do anything wrong, nor did the lender, but their situation, even if they don't default, isn't good for them—or for the country, as it reduces mobility, which is especially important during tough economic times when people need to move to areas in which jobs are being created.

The $132,000 Shack

The *Wall Street Journal* had another interesting story from Arizona,[12] this time about a shack that was appraised for $132,000, thereby justifying a loan of $103,000 against it. It was a 30-year ARM with an initial interest rate of 9.25 percent that was capped at over 15 percent. The mortgage broker collected $6,000 in fees at closing and pocketed another $3,000 selling the loan to Wells Fargo.

The borrower was Marvene Halterman, a 61-year-old former alcoholic who had not worked in over 13 years. The shack—you really have to see pictures of it to believe it—was in such poor condition that she eventually moved out and rented a place that was safer. Her son moved in but could not make the payments, so it was foreclosed on and a neighbor purchased it for $18,000 simply to tear the eyesore down.

Fraud

During the bubble, outright fraud was widespread, in part due to the laxness of lenders. The *New Yorker* article quoted earlier had another lengthy story about one con artist in Florida.

> Last fall, Michael Van Sickler, of the St. Petersburg *Times*, tracked the real-estate deals of a local tattoo parlor owner named Sang-Min Kim, also known as Sonny. Starting in 2004, Sonny Kim made ninety sales around Tampa, mostly in poor neighborhoods, on which he cleared four million dollars. Van Sickler found that many of Kim's buyers, who put little or no money down, were untraceable; some had been convicted of drug dealing and other crimes. Kim, who has not been charged with any crimes and could not be reached for this article, closed a third of his deals with a title agent named Howard Gaines, who now faces up to forty-five years in prison on a fraud conviction elsewhere in Florida. According to law-enforcement experts, drug dealers often become flippers, in order to launder money.
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> One night in December, Van Sickler took me on a tour of some of the abandoned and foreclosed properties that had once belonged to Sonny Kim's real-estate empire. We stopped at an ill-lit corner in a mostly black slum of single-family houses called Belmont Heights, which is cut off from downtown Tampa by Interstate 4. Van Sickler—incongruous-looking in a dress shirt and dark slacks—pointed out a decaying two-story stucco house.

Its windows were boarded up, and mattresses lay in the overgrown yard, near a "For Sale" sign. Van Sickler learned that Kim acquired the house in 2006 with a deed that was witnessed by a convicted drug dealer, then flipped it for the sum of three hundred thousand dollars, with the help of a no-money-down mortgage from a subsidiary of Washington Mutual Bank, which later foreclosed on the house. (Last year, WaMu went into receivership, after becoming the largest bank failure in American history.) According to mortgage-fraud experts, the straw buyer is typically paid a small slice of the flipper's take and then disappears without moving in. When Van Sickler recently asked a real-estate agent about the house, he was told, "That's selling for fifty-two thousand, but it can be yours for thirty-five thousand in cash."

"Sonny Kim may not be the biggest, he may not be the worst, but he really epitomizes the laxness of the banks during the boom years," Van Sickler said as we stood outside the house. "It raises the question, Did anyone from the bank do a drive-by to eyeball this place?" Kim's deals had been financed by Wachovia, Wells Fargo, Bank of America, Lehman Brothers, Fannie Mae, and Freddie Mac. While Van Sickler, who was having trouble selling his own house in Tampa, was investigating the trail of Sonny Kim in September, the country plunged into the worst economic crisis since the Great Depression, and the banks that had greased Kim's deals were at the center of it. "We're not *all* to blame for this," Van Sickler said. "Decisions were made, and people looked the other way. This did go all the way up the ladder."[13]

Conclusion

Now that we've seen how lending standards completely collapsed and the mortgage market became an orgy of utter depravity, from the individual homeowners all the way to the offices of Wall Street CEOs, in Chapter 2 we explore the reasons for this insanity.